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WORLD-WIDE BANKING CHASE MANHATTAN CHARTERED 1799

The resumption of steel output under the Taft-Hartley injunction should enable business activity to resume its advance in the near-term future. Nevertheless, the outlook is beclouded by uncertainty, pending a final resolution of the dispute.

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Steel inventories are at rock-bottom levels. Thus, steel shortages will plague production managers even after full steel production is attained. Moreover, production scheduling will be complicated by the question of what happens after the 80-day injunction period.

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From the viewpoint of the national interest, the problem is still that of achieving a non-inflationary steel settlement. The economy appears to be poised for a period of high-level activity as inventories of steel and products made of steel are rebuilt.

To achieve such an expansion, the uncertainties now surrounding production planning and price prospects need to be removed. Thus, the urgency of a settlement that contributes to increased productive efficiency and avoids the necessity of a steel price increase is not diminished by the Taft-Hartley injunction.

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In a real sense, the nation is facing a crucial test. A renewed shutdown of steel mills in January would again create a national emergency – steel output in the 80-day injunction period can do little more than match expected consumption.

However, a settlement which set off another wage-price spiral would not be in the national interest. Another round of inflation could lead to the sort of boom that has traditionally led to a serious and prolonged period of readjustment. It could further unbalance our international payments.

The challenge to our free institutions is to resolve the steel situation in a manner that will contribute to growth, prosperity and stable prices.

A constructive settlement in steel could lead to a period of substantial advance in production and employment. Postwar experience has shown that output lost during major strikes is made up after the strike – in an atmosphere of scarcities and strong demand for final products and inventories.

Consider the situation in major economic areas:

¶ **Steel inventories** are well below 8 million tons versus a "normal level" of some 20 million tons. Estimates are that it would take at least 6-9 months of near-capacity steel operations to rebuild stocks.

¶ **Auto output** in the fourth quarter will fall more than half a million short of schedules so dealer inventories will be low at year-end.

¶ **Business expenditures for new plant and equipment** are being held below scheduled levels by steel shortages. However, the preliminary McGraw-Hill survey of investment plans for 1960 reports an increase of 10%. Past surveys show that business tends to underestimate the amount of actual increase in times of expanding activity.

¶ **Consumer income and expenditures** held at a high level through the third quarter.

¶ **Exports** in the third quarter were 12% above the first quarter low (on a seasonally adjusted basis). Sales to Canada accounted for about one-third of the rise.

¶ **State and local government expenditures** rose during the third quarter, while Federal expenditures have leveled out.

¶ **Housing** declined a bit, but construction as a whole held level.

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The general picture shows that the expansion phase of the business cycle was interrupted by the steel strike. While some sales lost during the strike may not be carried over, it would appear that a large backlog exists. In other words, the strike, if it is resolved soon, will turn out to have cut supply much more drastically than demand.

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As a result, the period following a settlement could be one of inventory rebuilding, a scramble for supplies, and general pressure on costs and prices. Such developments could add to private demands on credit markets and pose new problems to the monetary authorities. Their tasks may be eased by a sharp reduction in the Treasury's takings during the first half of 1960. Yet the general situation would appear to be one that calls for continued tightness in money markets.

POTENTIAL SQUEEZE ON THE MORTGAGE MARKET

Will tight money lead to a cutback in residential construction next year? That is what happened in the last period of general business prosperity. Then, with financing difficulties the major roadblock, private housing starts dropped from 1.3 million units in 1955 to under 1 million in 1957. Now, many builders are concerned lest that earlier pattern repeat itself.

A Record Year for Mortgages

Initially stimulated by easy money, home building spurted ahead in 1958 and the first half of 1959. Through most of the last winter and spring, housing starts were maintained at an annual rate of 1.4 million, and they declined only moderately during the summer.

That high level of activity brought in its wake a huge demand for mortgage money. In the first nine months of this year alone, the net increase in mortgage credit ran to roughly $15 billion – equivalent to an annual rate of growth of over 11%.

So large a volume of mortgage financing – during a period of swiftly rising business activity and restrictive monetary policies – has inevitably been reflected in renewed market pressures. Mortgage rates have climbed to a postwar high. But even higher rates have not been able to attract enough funds from private lenders to satisfy all the current demands for mortgage money.

Sources of Funds

Some market forces point toward the possibility of even greater pressures over coming months.

• Commercial banks stepped up their mortgage purchases sharply this year. But now, with businesses and consumers also borrowing heavily, their loan/deposit ratios stand at the highest level in a quarter century. With deposit growth restrained by Federal Reserve policy, maintenance of satisfactory liquidity may soon dictate a reduced rate of mortgage buying.

• A further advance in capital spending by businesses in 1960 could bring corporate bond financing above the sharply reduced levels of this year. That might divert some funds from the mortgage market.

• The Treasury, in its highly successful sale of 5% notes in October, demonstrated its ability to attract funds of individuals away from savings institutions – and indirectly from the mortgage market. Even before that Treasury borrowing, savings and commercial banks found their savings inflow reduced as potential depositors shifted to higher-yielding investment outlets.

These factors should not obscure the fact that, in some ways, the mortgage market may be in a less vulnerable position than during the last period of tight money. Corporations, for instance, appear to be better placed for financing their capital spending from internal sources of funds – retained earnings and depreciation allowances. Consequently, corporate bond offerings may drain fewer funds from the mortgage market than in 1956 or 1957.

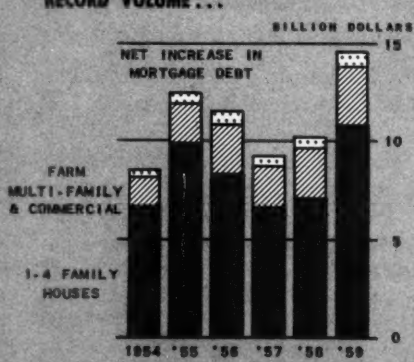
Furthermore, savings and loan associations – by far the largest source of mortgage money – have been able to step up their growth rate in 1959. They have absorbed roughly 40% of the increased mortgage volume this year, and could prove a strong sustaining factor in 1960.

Finally, fewer housing starts are now financed with low interest rate, Government-guaranteed mortgages. Thus, the special rigidities – and deep discounts – associated with that type of financing during periods of tight money may be a less potent restraining factor.

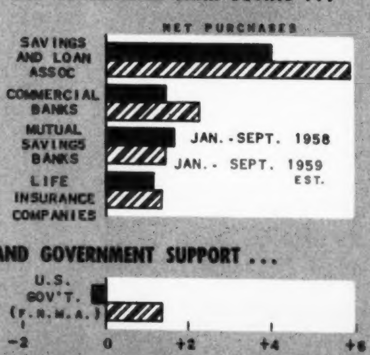
Conclusion

Whether these sustaining factors will permit the mortgage market to fare better in 1960 than in 1956 and 1957 is still problematical. In any case, with other areas of the economy expanding, a moderate decline in home building is probably inevitable. If counter-cyclical monetary policies are to be effective at all, they must restrict activity in some lines during boom periods, thereby releasing resources for more urgent needs. Only in that way can the fundamental objective of reasonably steady growth, without inflation, be achieved in the interests of the economy as a whole.

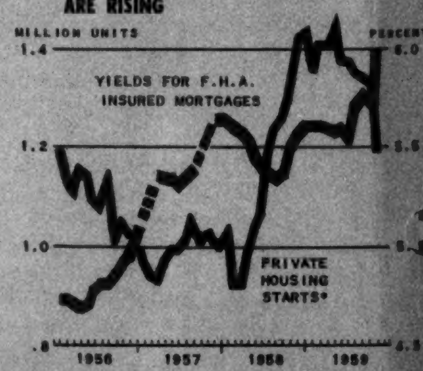
MORTGAGE MARKET ABSORBING RECORD VOLUME...



AIDED BY STEP-UP IN SAVINGS AND LOAN AND COMMERCIAL BANK BUYING ...



BUT PRESSURES ON MARKET ARE RISING



DATA: FEDERAL RESERVE BOARD AND OTHER GOVERNMENT AGENCIES; 1959 ESTIMATED BY C.M.B.

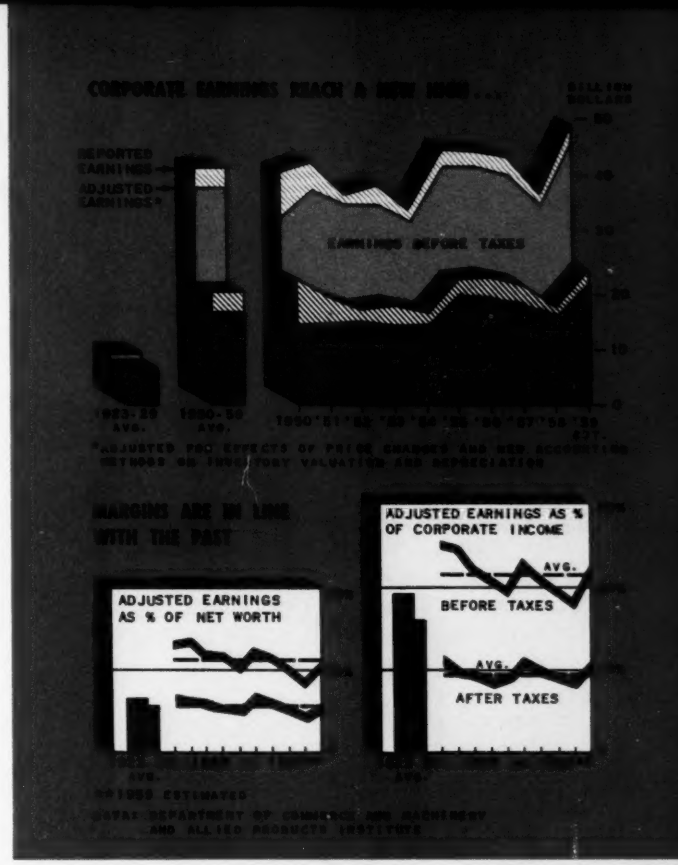
CORPORATE EARNINGS

Are They Adequate To Support Investment?

Corporate profits should reach a new high in 1959 despite the inroads of the steel strike. Recent estimates are that they may run 5-10% above the previous high of $44.9 billion in 1955.

A resurgence in corporate earnings is a typical feature of the recovery and expansion phases of the business cycle. In fact, profit margins in 1959 are below those in comparable stages of the postwar period. This year's before-tax earnings are estimated at 22% of national income originating in corporations compared to 23% in 1955 and 26% in 1950.

A major question for the economy, however, is whether the return on corporate investment is high enough to generate a continued expansion in corporate investment in new plant and equipment. Such investment plays an essential role in the advance in the economy's efficiency.



Accounting Problems

The conventional practices followed in reporting corporate earnings make it difficult to judge the adequacy of current and prospective profits as a source of funds to finance new investment.

- *Accounting* changes since the 1950's have tended to make reported profits *lower* than they would be under previous practices. Rapid amortization (begun in the Korean War and largely over now) permitted certain facilities to be written off in 5 years. More significantly, new and more realistic methods of depreciation, introduced in 1954, allow a more rapid write-off of physical assets than straight-line depreciation charge-offs allowed by previous Treasury rulings.

- *Inflation,* on the other hand, has made reported earnings artificially *high* through over-valuation of inventories and under-depreciation of fixed assets. The Commerce Department has adjusted reported profits figures for inventory valuation distortions. However, no allowance has been made for the effect of rising prices on depreciation.

How do these adjustments balance out? Estimates made by the Machinery & Allied Products Institute show that during the 1950's:

- Accounting changes have understated reported earnings by an annual average of $2.3 billion;

- Inflation has led to an overstatement of earnings by an annual average of $6 billion;

- Thus, real profits before taxes have been $3.6 billion (11%) less than reported profits before taxes.

Given these adjustments, how do profits line up in relation to the rest of the economy?

This year's adjusted profit margins (both before and after taxes) should be close to the average for the decade of the '50's when adjusted pre-tax earnings averaged 21% of corporate income and 11% of net worth. However, the margins are not as high as in some individual years. In fact, the statistical picture for the '50's appears to show a gradual decline in profit margins.

However, a longer-term comparison with the period of the 1920's shows that profits in the 1950's are:

- Slightly higher as a percentage of corporate income, when measured on a pre-tax basis;

- Lower in relation to income when measured after taxes – 10% of corporate income (or net sales) in the 1950's as against 16% for 1923-29;

- About the same in terms of profits after taxes as a percent of net worth.

Rate of Return Stable

In other words, the rate of return after taxes on invested capital has been as high in the 1950's as in the 1920's even though the return on net corporate sales has been less. This is explained by the fact that corporations have been producing more income per dollar of investment – in technical terms, the capital-output ratio has declined.

In more concrete terms, what is suggested is that the level of corporate earnings that could be attained following a viable steel settlement would suffice to finance an upsurge in business investment and provide an incentive to business managers to undertake such commitments.

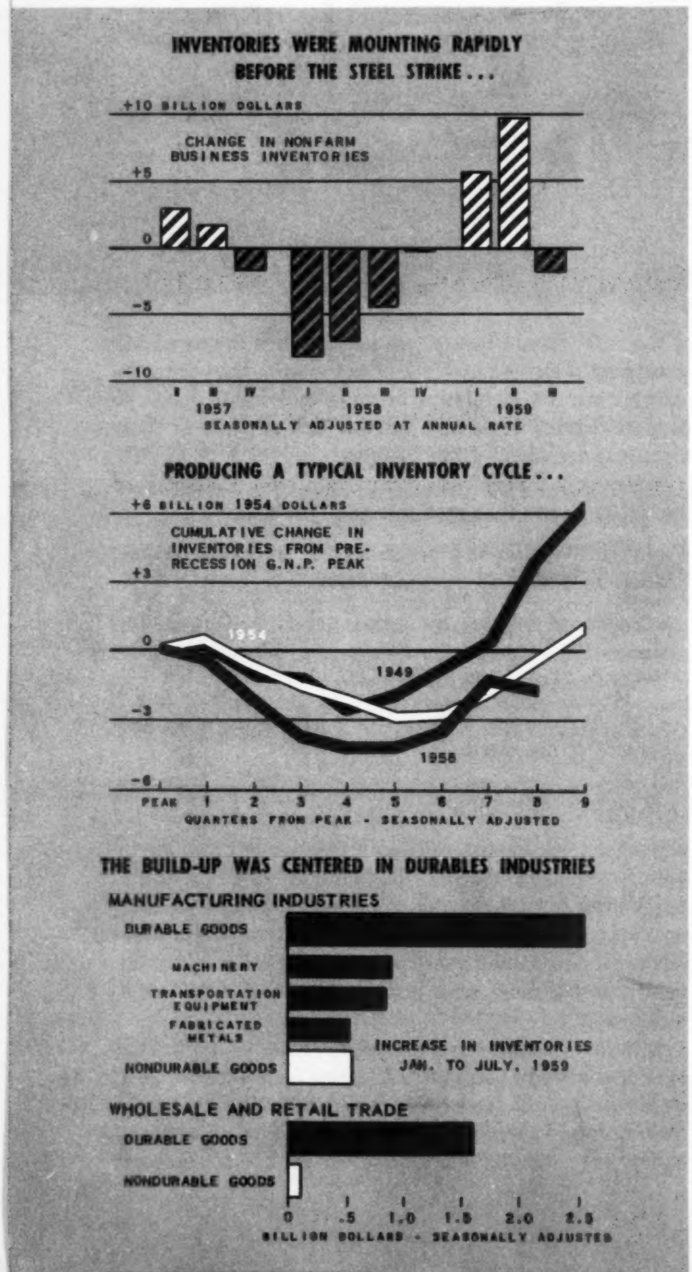
INVENTORIES

Build-up Ahead?

The past two years have witnessed a series of dramatic shifts in nonfarm business inventories. They were: 1) built up to record levels in the fall of 1957; 2) cut back $5 billion in the 1957-58 recession; 3) increased again in the first half of this year; and 4) drawn down during the steel strike.

These shifts in inventory policies have had significant impacts on business, for it is the *change* in inventories that affects new orders and then production. Thus, the switch from adding to nonfarm inventories at a $2 billion annual rate in the third quarter of 1957 to cutting them at a $8 billion rate in the first quarter of 1958 explained a major part of the decline in industrial production.

Such experience is typical of past business cycles. Studies of the National Bureau of Economic Research show that inventory liquidation has accounted on the average for more than half the decline in output in periods of business recessions since 1918. Increases in inventories have made up about one-fifth of the total rise in production during the nine periods of expanding activity in the same span of years.



Build-up in 1st Half 1959

In line with this business cycle pattern, inventories were built up at a rapid rate in the first half of the year. The annual rate of accumulation reached $10 billion in the second quarter – the highest level since the Korean War period. The increase was largely concentrated in durable goods industries, for two reasons:

- Inventory swings are typically wider in durables, reflecting the greater volatility of sales of durable goods in contrast to nondurable sales;
- Inventories of steel were being built up as a hedge against the steel strike.

During the first six months of the year, durable manufacturers' inventories rose $2.4 billion as against an increase of $550 million on the part of nondurable manufacturers.

Despite this rapid rise of accumulation, inventories were relatively low at mid-year. Ratios of inventories to sales, inventories to new orders, and inventories to gross national product were lower than in comparable periods of 1956, 1957 and 1958. What's more, the ratios were falling during the second quarter due to the rapid rise in general economic activity.

Steel Strike Impact

The steel strike led to a reduction in durables inventories during the third quarter. Through about mid-September the impact was felt chiefly in steel supplies as production of things made of steel was maintained. But since then steel-using plants have been forced to curtail operations, or in some cases to close down, for lack of steel.

Despite the resumption of steel operations, it is doubtful that durable goods inventories can be increased materially in the current quarter. Steel production will barely suffice to meet current consumption. And inventories of autos and other steel products may be drawn down further.

Meantime, inventories of nondurables have continued to rise. However, the latest figures show that, in general, they are still below their past "normal" relationship to sales.

Where We Stand

All in all, the clear prospect is that the economy will enter 1960 with nonfarm inventories definitely on the low side. This is significant since history shows that inventory accumulation makes a major contribution to expanding business.

How great might the accumulation be and how long might it last? These are key questions to which there are no certain and precise answers. Yet it may be helpful to compare our current inventory position with that in past periods.

A recent Commerce Department study shows that the postwar relationship between nonfarm inventories and gross national product has moved up and down cyclically around a figure of 23¢ of inventories for each $1.00 of GNP. It has varied between a low of 21.3¢ in the third quarter of 1950 and a high of 24.3¢ in first quarter 1958.

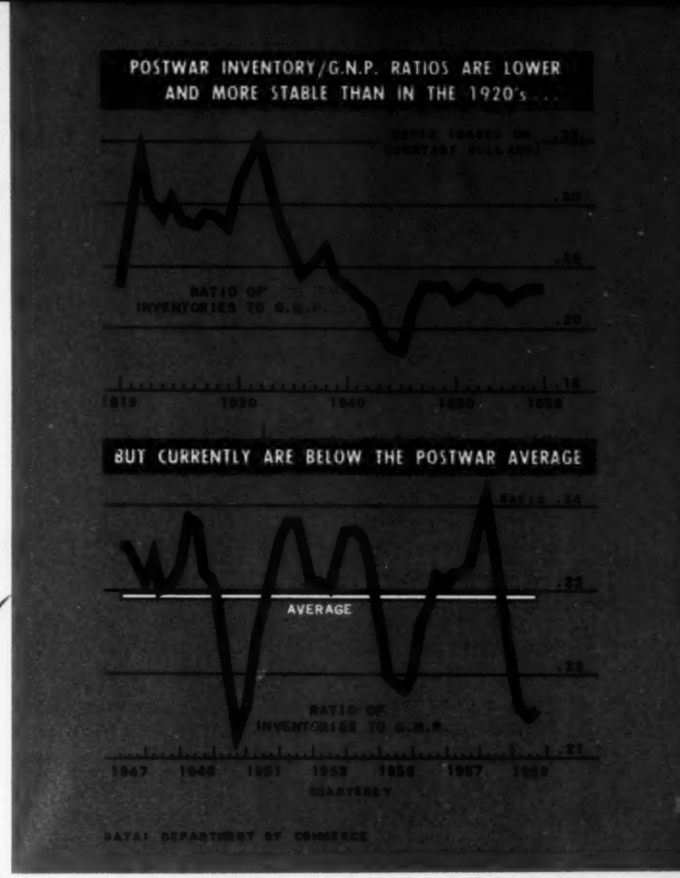
Interestingly enough, the fact that the ratio of inventories to GNP has shown no trend up or down in the postwar period represents a change in a long-term tendency. Statistics going back into the 1920's show a long-term downward movement in this ratio – from about 30¢ of inventories per $1.00 of GNP in the early 1920's to 18¢ per $1.00 at the end of World War II. Improved methods of distribution, like supermarkets, and the expanding use of truck transportation have been cited as major reasons for this growing efficiency in the use of inventories.

The general stability in the ratio – the 23¢ per $1.00 of GNP – in the postwar period means that other factors have assumed greater weight. Undoubtedly, the proliferation of models and styles in autos and other products has been an offsetting factor to continued improvements in the efficiency of the distribution and transportation of specific products.

The Picture for 1960

In any event, postwar experience suggests that the 23¢ to $1.00 ratio represents a normal relationship of inventories to GNP under present conditions. This means that business will try to add to inventories when the ratio is below this figure and reduce them if the norm is exceeded. In the third quarter of the year, inventories added up to 21½¢ for each $1.00 of GNP and the ratio may be lower at year-end. An increase of one-half cent in this ratio means an addition of almost $2½ billion to nonfarm inventories at the current level of GNP.

The other variable is, of course, gross national product. The very rebuilding of inventories will add to production and employment, boosting GNP. Such additions to production and employment will tend to increase spending in other sectors of the economy, further boosting gross national product. Then, if such other key economic factors as business investment in new plant and equipment, sales of autos and other consumer durables, exports and state and local government expenditures move ahead in 1960, a very substantial increase in inventories would be indicated for next year.



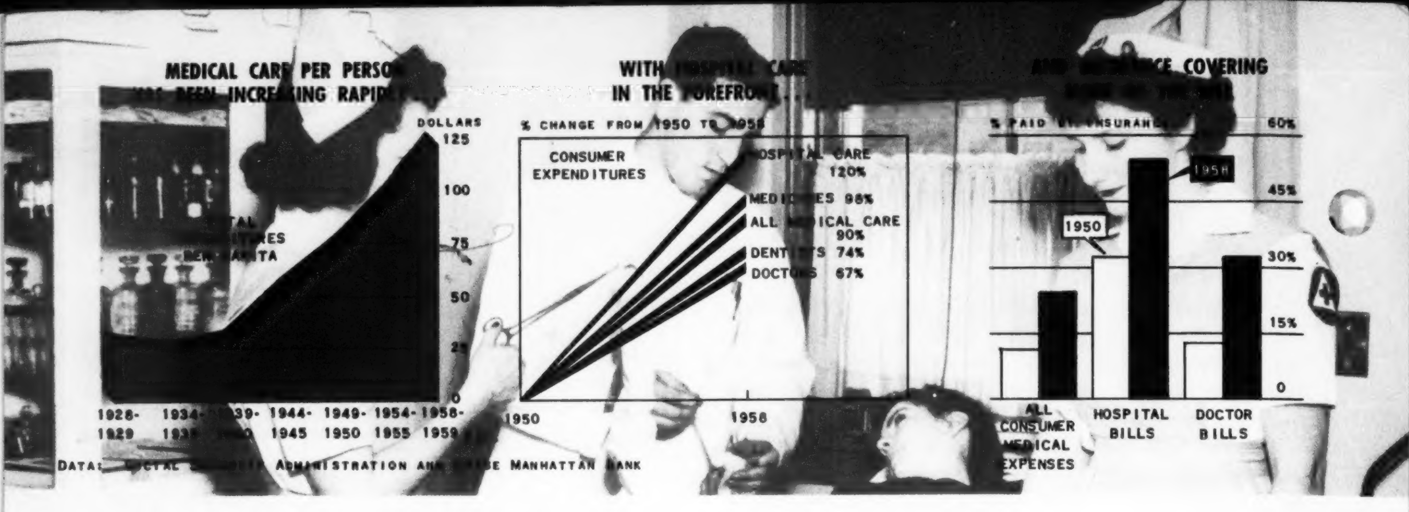
Duration of the Build-Up

Experience in the postwar business cycles indicates that the inventory-GNP ratio may decline for another six months or possibly longer – the cyclical expansion of GNP could outpace the growth in inventories. In each of the two previous cycles it has taken an additional three calendar quarters for the ratio to reach and pass the .23 to 1 ratio.

If this pattern should be repeated, the above-normal inventory build-up could run for as long as eighteen months. It should be emphasized that many factors, such as a change in business confidence regarding future sales trends, could make the pattern different in this business cycle.

Moreover, an upsurge in inventory buying in and of itself does not constitute sound footing on which to erect a period of prosperity. To the extent that inventory buying runs ahead of the normal rate of accumulation of around $4½ billion, new orders, sales and production are running ahead of the level of sustainable final demand.

Consequently, the sizeable move to rebuild inventories which could develop in 1960 will pose problems. It will add to demand at a time when supplies are short, particularly in the metals area. And the inevitable tapering-off of the annual rate of inventory building from high rates early in the year means that other areas of the economy must show increased vitality if over-all activity is to continue to advance.



FINANCING MEDICAL CARE

The nation's annual bill for personal medical care is now about $22 billion – double the amount in 1950 and more than 6½ times the 1929 figure. Some of this increase is due to population growth, with a larger proportion of children and older people. But most of it results from a rise in per capita medical expenditure from $27 in 1929 to $124 today. It is this rise, compounded by the inherent uncertainty of medical expenses, which underscores the problem of financing health care.

Behind the Rise

What is behind this sizeable increase in per capita expenditure? Analysis shows three major factors:

- New developments have enabled doctors to treat a wider range of illness, and more people take advantage of the benefits of competent medical care. Thus, about two-thirds of the population now see a doctor during the year compared with less than half the population thirty years ago. Moreover, the number of visits per patient has risen 40%.

- In addition, rising incomes and the spread of health insurance have enabled Americans to afford more medical care. Three families out of four have some health insurance. Three out of five have some coverage for all family members.

- Then, the cost of medical care has risen. Just how much is difficult to measure because some price increases are partly offset by improvement in quality. For instance, the charge for a day's stay in the hospital has gone up 73% since 1950, but modern methods of medical treatment have reduced the average length of stay by over one-eighth. More important, much of the care which is saving lives and improving health today had no counterpart ten, let alone thirty, years ago.

How is this larger medical outlay divided? Average expenditure per person lines up this way. Of the total $124, the largest portion, $37, is spent for hospital care. (This is the fastest growing area of medical service; it moved up to first place, after ranking behind payments for physicians, medicines and dentists in 1929.) Another $34 represents an average of about 5 physician visits. The rest is divided: $33 for medicine and appliances, $14 for dentists and $8 for other services.

These are average expenditures. By their very nature, medical bills are seldom average – they vary tremendously. Moreover, they are unexpected and outside the control of the family budget. The chances are 1 in 5 that a family's medical bills will exceed 10% of the family income, and 1 in 50 that they will exceed 50% of income.

Where does this money come from?

- About one-fifth of all expenses for personal medical care are paid by the government. Much of this care goes to servicemen or veterans and their families; some goes to recipients of public assistance or workmen's compensation.

- Another fifth of the total is now financed through health insurance. Over half the hospital bills and one-third of the doctor bills are paid via insurance.

- The rest, $3 of every $5, is paid out-of-pocket by patients. To pay these bills, an estimated 7.5 million families have debt outstanding, and many people have withdrawn funds from their savings.

By contrast, in 1929 people paid 90% of the medical bills out-of-pocket, the government contributed less than 10%, and health insurance a negligible amount.

Progress in Insurance

It is clear that considerable progress has been made toward absorbing the financial burdens of illness. Over 120 million Americans now have health insurance, ten times the number in 1940. Policy provisions are being steadily broadened to offer greater coverage, and more people are subscribing to the major medical expense plans. Also, new policies are being tried with provisions to encourage people to keep healthy through regular checkups and preventive medicine. Thus, while we still have some distance to go, we are moving toward a more orderly pattern of financing medical care.

THE FARM OUTLOOK

American farming continues to present a paradox. Agricultural output in 1959 is surpassing last year's high, but net farm income may be down as much as $2 billion by year-end. And the outlook for 1960 is for more of the same — high production, pressure on prices, weakness in income.

Bumper Crops and Changing Income

The present picture is in contrast to last year. At that time, with prices down only fractionally, crop output rose an unusual 11%, bringing an increase of $1.8 billion in cash receipts from crop marketings. Meanwhile, livestock prices moved higher, notwithstanding a moderate increase in output, so that receipts from livestock marketings raised gross income by another $2 billion. Altogether, net farm income rose over $2 billion, after allowing for the increase in production expenses.

This year the components add up differently. Crop production equals last year's record, but prices have slipped further. This factor, together with lower Government payments (due to the discontinuance of the acreage reserve program of the soil bank), has produced a small decline in crop receipts. Livestock receipts are also off as the pressure of increasing supplies brought a 7% drop in average livestock prices. Hog prices are down about one-third from year ago levels, and slaughter for the year is expected to be about 12% above 1958. Cattle prices, after two years of advance, have started to ease, and beef production is beginning an uptrend which is expected to continue next year.

When we add up these facts, we find that gross receipts of farm operators will have fallen by more than $1 billion by year-end. The pinch on net income is even greater — perhaps as much as $2 billion — as production expenses continue to rise. What is the impact of these trends in output, prices and income?

Lower Income per Farm

For the farm economy, the fall in net income means lower income per farm. However, since 1948, when farm income hit an all-time high, the number of farms has gone down from 5.8 to 4.6 million. Thus, a drop of one-third in total net income from 1948 to 1959 has been held to a 15% decline in net income per farm.

Ordinarily, lower 1959 income per farm would be reflected in the spending patterns of farmers. However, the impact has been cushioned by the significant improvement in farm income last year — when income per farm barely fell short of the 1948 record. In addition, income of farmers from non-agricultural sources is up this year and will account for 35% of farmers' total income.

- Accordingly, expenditures for agricultural machinery are up an estimated 15% this year. Rising labor costs continue the pressure to mechanize; replacement demand for equipment is growing.

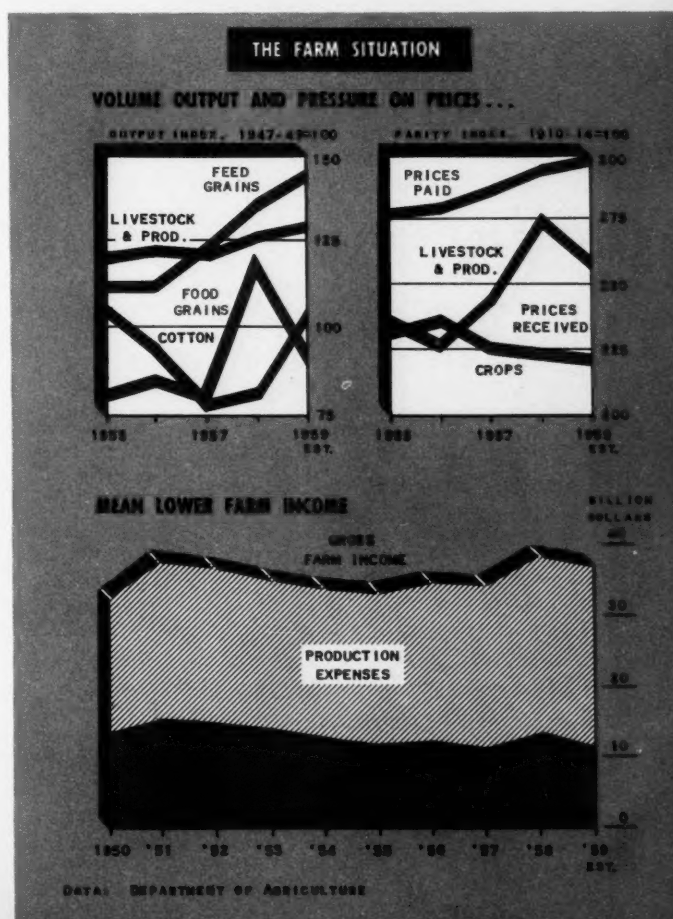
- At the same time, the fall in farm income appears to be taking some of the buoyancy out of the farm real estate market. The March to July rise of 1% in rural land values was the smallest since 1956.

The Government and the Farmer

In spite of changing income, the long-run trend towards larger, better-equipped farms continues. And further increases in productive efficiency can be anticipated, auguring continuing price support and surplus problems.

As matters now stand, wheat and corn carryovers are at record levels, while the cotton carryover — though well below the 1956 high — is above last year. Altogether Federal government investment in surpluses may pass the $10 billion mark by early 1960. The annual cost of storage, transportation, and interest on these surpluses now runs to $1.2 billion a year. Total Federal budget expenditures for income and price support may be $4½ billion in fiscal 1960. While this is down from fiscal 1959's $5.1 billion (largely because of discontinuance of the acreage reserve program), it stands well above the $3.5 billion average of 1955-58.

The farm problem thus remains. Under present programs, Government spending remains high, but the dilemma of high level output and growing surpluses, combined with unstable prices and incomes, stands unsolved.



Snug harbor for shipping

. . . the future of the Port of New York looks good to the people at Chase Manhattan

Counting sleek liners, low-slung tankers, and freighters from far-off ports, a ship now enters or leaves New York Harbor every 20 minutes.

Nearly a million international travelers come and go via ship through the Port each year, and the annual movement of freight averages about 140 million tons.

It takes 200 deep-water piers to handle these ship movements.

It takes a lot of people and equipment, too. Private business firms join hands with public agencies, the Army Engineers and the Coast Guard to keep the Port of New York going full speed.

Developing the Port is primarily the responsibility of two public agencies, the Port of New York Authority, a self-supporting corporate agency of the states of New York and New Jersey, and the New York City Department of Marine and Aviation.

In developing new waterfront facilities on a self-sustaining basis, these two agencies are planning expenditures of more than $580,000,000 along the Port's 650 miles of waterfront.

But more important than these cold figures is the impact modern marine terminals make on a population of 13 million people in the New York-New Jersey area.

A busy, look-ahead seaport provides jobs for men and women, customers for competitive business. And whenever people work and goods move, prosperity follows.

The Chase Manhattan Bank, New York's largest commercial bank, provides money, credit and financial services for the many public agencies and private enterprises that serve the Port of New York.

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